AVOIDING COMMON LEGAL MISTAKES MADE BY STARTUPS

Launching a startup business has many challenges that could become potholes unless the founders are diligent and thoughtful. Often times, mistakes are made during the formation stage as the company begins to grow and, also, when dealing with employees. An important first step in beginning a business with other parties is to agree and clearly outline the nature and scope of the relationship. Outlining the roles and responsibilities of the founders and the time commitment they are expected to contribute is paramount in maintaining consistency and succession. Failure to check this box could lead to expensive litigation and major issues with potential investors. Other issues to address early on in the process include:

Equity & Vesting

Determining how equity will be allocated and vested is essential to avoiding mistakes from the start. It is also critical that founders remain engaged in the company's success. If a founder departs from the business, the remaining founders must make certain they have the right to purchase his or her stock at a specified price.

Compliance

Compliance with securities laws is extremely important for the founders, regardless of the structure of the company. The sale of stock or a membership interest may be subject to federal and/or state securities laws which require disclosure and filings unless the offering is determined to be exempt from regulation. The failure to comply with applicable securities requirements could result in penalties or possibly an order to repurchase the shares that sold to investors if the offering is determined to have been unlawful.

Tax

Addressing key tax issues relating to the business early and often is another area of concern for the founders that requires professional assistance in order to avoid future issues. Examples include obtaining a tax identification number, choosing the most appropriate form of entity, i.e., a Pass-Through or C Corporation (which is often desired by investors).

Operations and Payroll

The daily operation of the business and how decisions will be made should be addressed early in the process of formation. Of consideration is whether decisions will be made by majority vs. unanimous vote and which responsibilities will be delegated to a Chief Executive Officer, who would report to the board. Another critical decision to be made early on is establishing the criteria for removing a board member or founder; the mechanics of establishing a purchase price for future ownership and the overall goals of the business which should be reviewed routinely by the board. Dealing with the status of those who will serve the company as employees or independent contractors is another area of concern that must be addressed in a comprehensive manner in order to avoid disputes and possible litigation.

Governance

Once the business is fully operational it is important that leadership follow proper corporate governance procedures and maintain detailed records relating to board decisions, contracts, shareholder agreements and amendments. A major mistake that could sink a startup is the failure to develop and implement the use of a proper form of employment agreement or offer letter that specifies job title, duties and responsibilities, salary and benefits, rights regarding termination, confirmation of the nature of the relationship, how disputes will be addressed, chain of command, confidentiality and protection of intellectual property rights of the company.

In conclusion, if a startup avoids many or most of the critical mistakes outlined above, the chance for success improves exponentially. Investing in proper planning and professional assistance will provide a better opportunity for success, as will having a predetermined game plan to address issues that may occur in the future. For further information on starting a business, please contact PLDO Managing Principal Gary R. Pannone at 401-824-5100 or email gpannone@pldolaw.com.

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